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IN THE

Supreme Court of the United States

October Term, 1973

No. 73-517

EARL VEST AND FAY VEST,
Petitioners,

versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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IN THE
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EARL VEST AND FAY VEST,
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Respondent.

PETITION FOR WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

TO: THE HONORABLE WARREN BURGER, CHIEF JUSTICE OF THE UNITED STATES AND THE ASSOCIATE JUSTICES OF THE SUPREME COURT OF THE UNITED STATES.

By this Petition, Earl Vest and Fay Vest, respectfully seek a writ of certiorari to review part of the judgment and opinion in this case of the United States Court of Appeals for the Fifth Circuit.

I. OPINIONS OF THE COURTS BELOW.

The trial court, the United States Tax Court, made findings of fact and rendered its opinion which are reported in 57 TC 128, involving four separate and unrelated issues, only two of which were appealed and only one of which is the subject of this Petition. In view of the length of the Tax Court findings and opinion which do not relate to the issue here presented, and the orderliness thereof, only the germane portions of the Tax Court's findings of fact and opinion are reproduced as Appendix "A" appended hereto. The opinion of the Court of Appeals is appended hereto as Appendix "B". It is reported in ____ F.2d ____.

II. JURISDICTIONAL STATEMENT.

The judgment sought to be reviewed, reproduced as Appendix "C" hereto, was entered on June 22, 1973. The order denying a rehearing was entered on August 8, 1973, and is set forth as Appendix "D". The statutory provisions believed to confer on this Court jurisdiction to review the judgment in question is Section 1254 of Title 28, United States Code.

III. QUESTION PRESENTED.

Is the right to be paid for a natural deposit (in this case, water rights in certain lands), a "retained economic interest", if the payments are measured by water sold or used from or transported across properties in which the seller owned nothing, and in which the buyer might not have any ownership? The Tax Court

held that such a right of payment is not a "retained economic interest", and the Court of Appeals, at the urging of neither party, held that it is.

IV. LAWS AND REGULATIONS WHICH THE CASE INVOLVES.

The "economic interest" concept is one which is used to determine a number of important income tax consequences. In this case, "retained economic interest" classification determines whether payments for property sold are to be deemed proceeds from the sale of a capital asset, or are ordinary income. Another use of the concept is to determine who may be entitled to depletion allowances, and in this regard the Treasury Department, in 1960, adopted a definition of "economic interest" in Treasury Regulations Section 1.611-1(b) (1), as follows:

> Annual depletion deductions are allowed only to the owner of an economic interest in mineral deposits or standing timber. An economic interest is possessed in every case in which the taxpayer has acquired by investment any interest in mineral in place or standing timber and secures, by any form of legal relationship, income derived from the extraction of the mineral or severance of the timber, to which he must look for a return of his capital. But a person who has no capital investment in the mineral deposit or standing timber does not possess an economic interest merely because through a contractual relation he possesses a

> mere economic or pecuniary advantage derived from production. For example, an agreement between the owner of an economic interest and another entitling the latter to purchase or process the product upon production or entitling the latter to compensation for extraction or cutting does not convey a depletable economic interest. Further, depletion deductions with respect to an economic interest of a corporation are allowed to the corporation and not to its shareholders.

This Regulation was amended in 1973 to incorporate an exception made by the adoption of Section 636 in 1969, pertaining to production payments as economic interests.

V. STATEMENT OF THE CASE.

This is an income tax case initiated by Petitioners in the United States Tax Court under the authority of Sections 7442 and 6213 of Title 26, United States Code.

In 1963, by Warranty Deed, Petitioners sold to Shell Oil Company water rights in certain underground strata, in certain lands in Winkler County, Texas, in perpetuity, without any requirement that Shell do, or not do, anything with them. Petitioners did exact from Shell the duty to pay the purchase price therefor, if, as and when due. Petitioners excepted from the conveyance water required for use in exploration and production of minerals from those lands (an exception which Respondent does not regard as consequential.

Rev. Rul. 73-341, IRB 1973-34, p. 22) (App. 94-96). With the water rights, Petitioners sold an easement across the land for one trunk water pipeline (App. 96), and granted Shell an option to purchase other water line easements (App. 78).

While the water right and easement grants were in perpetuity (App. 94-97), the right to be paid was not. Rather, the right to be paid was limited to 75 years (App. 79). The purchase price payments were to be computed in relation to the amount of "purchase price water" that is (1) produced from the water rights conveyed; (2) water transported using the trunk water line easement granted by Petitioners'; (3) water produced from other lands in which Shell acquired water rights in Ector, Ward and Winkler Counties, Texas, in April, 1963; (4) water transported by Shell using other easements acquired in April, 1963; (5) under certain conditions, water produced from water rights already owned by Shell; (6) water produced from water rights which Shell might later acquire; and (7) water transported by Shell in the county, either gratuitously or for hire. The payments are based on Shell's sales price of the water to an ultimate user or the value of water used by Shell, at the ends of its pipelines, not on wellhead values, and on transportation charges made for water merely transported by Shell, and if such are less than specified amounts, those specified amounts per barrel are used in the computation (App. 76, 80-83). In effect, to finance its acquisition of the fee water rights, and easements, Shell afforded Petitioners an economic advantage by agreeing to pay Petitioners for 75 years a portion, which might

exceed 100%, of the future revenues it might derive from the conduct of water sale, use and transportation businesses conducted in and about Winkler, Ward and Ector Counties, Texas.

Shell has never drilled wells or removed water from Petitioners' land nor has it laid pipelines on Petitioners' land (Stipulation of Facts, page 93). The purchase price payments for the tax years in question, of necessity, derived from water rights and Shell's efforts as a transporter and seller or user of water, in none of which did Petitioners ever have an investment.

Petitioners reported to the Internal Revenue Service all Shell payments as proceeds derived from the sale of capital assets, in the belief that they had retained no "economic interest" in the water right deposits. Respondent claimed the proceeds are ordinary income, not because Petitioners had retained an "economic interest", but because, in Respondent's opinion, the "economic interest" test should not be decisive of the capital gain - ordinary income dichotomy in water right cases.

VI. REASONS FOR GRANTING THE WRIT.

For more than 25 years, those involved in natural deposits in place transactions have been laboring under the limitation thought to have been imposed by *Anderson vs. Helvering*, 310 U.S. 404 (1940), and surely imposed by *Charles Burke*, 5 T.C. 1167 (1945), that to qualify as a "retained economic interest", its holder, for the return of his investment, must solely rely on

production from the property interest that he had conveyed, and in which he had kept his retained rights. Under these cases the ability to be paid from any other source, even production from another undivided interest in the same natural deposit in the same tract of land, is fatal to classification as a "retained economic interest".

The Court of Appeals below has said otherwise, holding that taxpayers have a "retained economic interest" in a transferred water deposit in given lands as long as their right to payment is inextricably linked to water, no matter that such water was neither produced from nor transported across lands in which the taxpayers had ever had an investment or other interest.

This distinction is critical to everyone dealing in natural deposits in place. If the Court of Appeals is correct, then *Charles Burke* is inoperative, its interpretation of *Anderson vs. Helvering* is too narrow, and, following the consequences flowing from the economic interest concept, there emerge new and important opportunities to shift risks and undesirable income tax consequences. If the Court of Appeals is wrong, and *Anderson vs. Helvering* and *Charles Burke*, taken together, are expressive of the law, all having business in natural deposits should like to know it before reliance on the holding of the Court of Appeals is misplaced. The interpretation of *Anderson vs. Helvering* made in *Charles Burke*, and the opinion of the Court of Appeals cannot coexist together, either one or the other expounds a basic fundamental of income taxation of a basic and fundamental segment of industry.

VII. ARGUMENT.

The "retained economic interest" test is being used to determine whether payments made in a given transaction in a natural deposit in place are to be classified as subject to capital gain taxation, or as ordinary income, subject to depletion if authorized. See *Wood vs. U. S.*, 377 F.2d 300 (C.A. 5, 1967), and the cases from the other circuits following its lead.[1] If an economic interest is retained, payments are generally regarded as ordinary income. If the right to payment is not classified as a "retained economic interest", the transaction may qualify for capital gains taxation.[2] The economic interest concept is also used to determine who must report income on the receipts from production,

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[1] *Royalton Stone Corp. vs. C.I.R.*, 379 F. 2d 298 (C.A. 2, 1967); *Schreiber vs. U.S.*, 382 F. 2d 553 (C.A. 7, 1967); *Hair vs. C.I.R.*, 396 F. 2d 6 (C.A. 9, 1968); *Alkire vs. Riddell*, 397 F. 2d 779 (C.A. 9, 1968); *Gitzinger vs. U.S.*, 404 F. 2d 191 (C.A. 6, 1968); *Belknap vs. U.S.*, 406 F. 2d 737 (C.A. 6, 1969); *Oliver vs. U.S.*, 408 F. 2d 769 (C.A. 4, 1969); *Hartman Tobacco Company vs. U.S.*, 471 F. 2d 1327 (C.A. 2, 1973), en banc, overruling *Barker vs. C.I.R.*, 250 F. 2d 195 (C.A. 2, 1957); *Don C. Day*, 54 T.C. 1417(A) (1970).

[2] Outside of the oil and gas field, the decided cases since the *Wood* decision have not focused on the nature of the initial payment made in transactions in which the retained interest is a production payment, i.e., a right to payment from production which is of shorter duration than the life of the interest transferred. *Thomas vs. Perkins*, 301 U.S. 655 (1937), which provided a cornerstone for the ABC transaction, treats such a transaction as a sale, so that the initial consideration may be taxed as capital gain. Section 636 of Title 26, U.S.C., enacted in 1969, to denude conventional production payments of their status as economic interests, while destroying the effectiveness and desirability of the use of production payments in the ABC transaction, does not purport to change the rule of *Thomas vs. Perkins* as it affects the ordinary income-capital gain dichotomy.

who is entitled to depletion, the deductibility, and who is entitled to it, of intangible drilling expenses and operating costs, and the need to capitalize costs of acquisition of deposits in place. The concept is said to be the bedrock on which any understanding of mineral tax law is built. See *Sneed, the Economic Interest - An Expanding Concept,* 35 Tex. L.R. 307, 308 (1957).

The term "economic interest" first appeared in *Palmer vs. Bender,* 287 U.S. 551 (1933), in which the court determined that the requisites of an economic interest are: (1) that the taxpayer has acquired by investment an interest in the mineral in place, and (2) secured by legal relationship, income from the extraction of minerals to which he must look for the return of his capital. The second factor has been interpreted to mean that the taxpayer must look solely to the extraction of the mineral for a return of his capital. *Commissioner vs. Southwest Exploration Co.,* 350 U.S. 308 (1956), citing *Anderson vs. Helvering,* 310 U.S. 404 (1940).

In 1938, in *Helvering vs. Bankline Oil Co.,* 303 U.S. 362 (1938), Mr. Chief Justice Hughes invented the phrase "economic advantage" derived from production of a mineral, as distinguished from an "economic interest", which is applicable to situations in which the person in question had no interest in the mineral in place, i.e., had no capital investment in the mineral deposit. This distinction Respondent recognized in promulgating Treasury Regulation Section 1.611-1 (b) (1). This distinction forms the basis for the holding

that a "bare right measured by production does not constitute an economic interest" as made in *Commissioner vs. Remer*, 260 F.2d 337, 340 (C.A. 8, 1958), affirming 28 T.C. 85 (1957).

Anderson vs. Helvering, decided in 1940, involved the sale of oil and gas rights in which the seller was to receive one-half of the production from the interest sold until a specified amount was received, either from production or the sale of the fee interest in the surface and mineral estates. The right to look to the sale of the fee was held by the Court to deprive the production payment of its status of an economic interest since the seller was not solely dependent on the production for the return of his investment. This had the effect of causing the buyer, rather than the seller, to be taxable on the income from the one-half of production that was retained throughout the payout and, following suit, resulted in the treatment of the proceeds as derived from the sale of an asset which may be subject to capital gain.

In 1945, the Tax Court, in *Charles Burke*, had before it a situation in which a seller, Signal Hill, sold and conveyed an undivided 4/24ths interest in the Fred Lee lease to the Burkes who already owned another undivided interest in the lease, and in exchange therefor, the buyers granted to the seller a production payment payable from an undivided 7/24ths of production from the lease. The issue was whether the seller had retained an economic interest in the fractional interest sold. The government claimed, and the Tax Court held, that *Anderson vs. Helvering* applied to prevent the sel-

ler's interest in production from qualifying as an economic interest because of the seller's ability to resort to a larger share of production than the seller had had, even though it was in the same type of production, from the same deposit and even from the same lease. As a result, the buyer was held to be taxable on all of the income that went to the seller attributable to the production payment. These payments would, of course, need also to be capitalized by the buyers.

In *Standard Oil Company (Indiana) vs. Commissioner*, 465 F.2d 246 (C.A. 7, 1972), the Court of Appeals for the Seventh Circuit also interpreted the "solely out of production" limitation of *Anderson vs. Helvering* as relating "to assets other than the specific rights transferred", 465 F.2d, at 351.

Commentators have also been teaching that *Anderson vs. Helvering* and *Charles Burke* cause destruction of economic interest status if the holder of the right in question may look to assets for the return of his investment other than the specific rights transferred. See *Hogan, The Tax Implications of Certain Transactions Involving Oil and Gas Interests Which Should Be Recognized By The General Practitioner*, 7 Rocky Mountain Mineral Law Institute (1962), 613, 637; *Berger, Taxwise Drilling and Financing of Wells*, 6th Annual Southwestern Legal Foundation Institute on Oil and Gas Law and Taxation, 505, 518; *4 Mertens, Law of Federal Income Taxation*, Sec. 24.60, p. 330.

If, from their tract of land, Petitioners have retained an economic interest in Shell's water business, the income tax consequences of their 1963 transaction with

Shell which follow are (1) Petitioners are taxable at ordinary income rates on that which Shell pays them and presumably are entitled to amortize their adjusted cost basis, if any, in the assets sold over the 75 year payout; and (2) Shell may exclude from its gross income from its water business the amounts paid to Petitioners, and is to be required to capitalize nothing paid for its acquisition of Petitioners' water rights. If Petitioners' right to payment from Shell is not a "retained economic interest", (1) Petitioners are required, as they have done, to report all receipts derived from Shell as long-term capital gain; and (2) Shell must include in its gross income all receipts derived from its water business as ordinary income, may not deduct therefrom the amounts paid to Petitioners, and must capitalize all amounts paid to Petitioners. Shell's recovery of its capitalized costs may not be amortized because its rights are perpetual and because the productive life of the property presumably is indeterminable due to recharge factors. Even in dealing in natural deposits for which there are statutory depletion allowances, capitalization of costs of acquisition is generally wasted on the taxpayer until the properties are sold, and is to be avoided if at all possible.

Anderson vs. Helvering and *Charles Burke* have served to curb transactions in which capitalization of leasehold acquisition costs may be avoided inasmuch as most owners of valuable natural deposits are unwilling to either lease or sell the same without an assured payment of some sort, and, in leasing transactions, one that is subject to statutory depletion allowances. Higher bracket taxpayers, in handling more valuable mineral deposits, tend to prefer to receive

deferred, assured payments to keep such amounts out of the higher tax brackets. However, in leasing transactions, they find that the familiar installment payment election of Section 453 (b) of Title 26, U.S.C., does not apply, and that a deferred bonus arrangement and any effort to obtain capital gain treatment thereof may be hazardous in view of *Cowden vs. Commissioner*, 289 F.2d 20 (C.A. 5, 1961).

If the Court of Appeals below is correct that one retains an economic interest in a natural deposit that is transferred to another as long as payment is inextricably linked to production of the same generic class as that which may be attributed to the transferred natural deposit, unless the consequences following from ownership of economic interests are changed, no imagination is required to conceive of how transactions may be made to eliminate or alleviate the undesirable tax strictures which have heretofore existed. By dealing so that little or no cash is paid on consummation, and by the retention by the seller of a royalty or an overriding royalty, of which includes a fraction of production from other known reserves with predictable producing capacity of the same generic class, the practical considerations of both the buyer and the seller stand to be solved without tax disadvantages to either. Those with retained economic interests, such as the royalty or overriding royalty measured by two or more properties, having tax brackets which are, or become too high to permit of their continued ownership, may sell at capital gain all or any undivided part of their royalty or overriding royalty in a sale transaction (which might qualify under the installment sale provisions of the Code) in favor of a lower bracket

taxpayer. See *U.S. vs. Witte*, 306 F.2d 81, 88 (C.A. 5, 1962). Thus, the ABC type of transaction becomes revived, and even made to work in the leasing of properties which are not yet productive.

CONCLUSION

The Court of Appeals has surely reached a significant conclusion affecting the modes of dealing in natural deposits and the financing thereof. Petitioners believe the Court of Appeals to be in error, that *Anderson vs. Helvering* is to the contrary, that the Tax Court below and in *Charles Burke* was correct, and that Petitioners, in their 1963 transaction with Shell, properly relied on *Anderson vs. Helvering* and *Charles Burke*. In either event, the conflict needs final resolution, before further reliance on either line of cases proves to have been misplaced.

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